BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
SAM ARMSTRONG REALTY, INC. and)
SAMUEL J. AND BETTY S. ARMSTRONG)

Appearances:

For Appellants: Robert Stark, Comptroller
Sam Armstrong Realty, Inc.

For Respondent: Mark McEvilly
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Sam Armstrong Realty, Inc., against a proposed assessment of additional franchise tax in the amount of $6,533.00 for the income year ended October 31, 1976, and pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Samuel J. and Betty S. Armstrong against proposed assessments of additional personal income tax in the amounts of $4,072.68 and $2,375.77 for the years 1975 and 1976, respectively.

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These appeals have been consolidated, for hearing and disposition because they present both a common factual situation and issue for determination. For purposes of convenience, Samuel J. Armstrong. and Sam Armstrong Realty, Inc., shall hereinafter be referred to as "appellant" and "Realty,", respectively, and collectively as "appellants;"

For several years prior to 1969, appellant owned and operated a real estate brokerage business as a sole proprietorship. In October of that year, appellant incorporated the business as Sam Armstrong Realty, Inc; the record of this appeal does not disclose appellant's motivation for incorporating his business.

During the course of its business activities, Realty occasionally purchased some of the properties that it had been commissioned to sell. These properties were either returned to the market and sold, or "purchased" by Armstrong Investments, a sole proprietorship owned by appellant. These latter "purchases" were accomplished merely by entries on Realty's books; title was never transferred. In addition to the above described "purchases," Realty also acquired title to certain properties which appellant intended to purchase on his own account. While the parties selling the properties to Realty dealt with the latter as a corporate entity, income derived from these properties was transferred by Realty's comptroller to appellant's individual account. Furthermore, appellant personally paid for the property taxes, capital improvements, insurance, and mortgage expenses relative to these properties. In addition to the activities described above, Realty employed a number of salesmen during the appeal years and paid applicable payroll taxes.

Upon audit of appellant's personal income tax returns for 1975 and 1976, respondent determined that the income and losses derived from the rental and sale of the properties under discussion should be attributed to Realty, rather than to appellant. The resultant notice of proposed assessment reflects, in part, the fact that the favorable treatment of capital gains available to individuals pursuant to Revenue and Taxation Code section 18162.5 is not available to corporations. Appellant argues that Realty acquired bare legal title to the subject properties, and that he held equitable title personally. He contends that the "substance" of these transactions should prevail over the mere "form"

of title. Finally, appellant asserts that he 'acted in a manner consistent with an Internal Revenue Service appellate compromise for the 1971 tax year with respect to his method of holding title.

The issue presented by this appeal is whether respondent properly determined that the income and losses derived from the sale and rental of the properties in issue were to be attributed to Realty rather than to appellant.

The question of whether a corporation is to be treated as a viable separate entity or ignored for tax purposes has frequently presented itself. (See, e.g., Moline Properties, Inc. v. Commissioner, 319 U.S. 436 [87 L.Ed. 1499] (1943); National Carbide Corp. v. Commissioner, 336 U.S. 422 [93 L.Ed. 779] (1949); Harrison Property Management Co.', Inc. v. United States, 475 F.2d 623 (Ct. Cl. 1973); Love v. United States, 96 F.Supp. 919 (Ct. Cl. 1951); David F. Bolger, 59 T.C. 760 (1973).) The general rule is that the corporate entity will be ignored only in exceptional situations where it would otherwise present an obstacle to the protection or enforcement of public or private rights. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934).)

In Moline Properties, Inc. v. Commissioner, supra, the United States Supreme Court held that a corporation should be recognized as a separate entity for tax purposes when the purpose for which it was created, is the equivalent of business activity-or when it subsequently engages in business activity. The Court expressed the rule as follows:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal-or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. (Moline, supra, 319 U.S. at pp. 438-439.)

The Moline "business activity" test has been explained as meaning that in order for a corporation to be treated as a separate jural person for tax purposes, it must engage in some industrial; commercial or other business activity. (National Investors Corp. v. Hoey, 144 F.2d 466 (2d Cir. 1944).) Although business activity is required for recognition of the corporation as a separate taxable entity, the activity may be minimal. While many of the cases in this area emphasize the degree of business activity,, a determination of whether a corporation is doing business does not necessarily depend upon the quantum of business activity. (Britt v. United States, 431 F.2d 227, 234-237 (5th Cir. 1970); Herbert v. Riddell, 103 F.Supp. 369 (U.S.D.C. S.D. Ca. 1952); see also Paymer v. Commissioner, 150 F.2d 334 (2d Cir. 1945).)

The leading case in drawing a fine line separating business from nonbusiness activity is Paymer v. Commissioner, supra. (See also Commissioner v. State-Adams Corp., 283 F.2d 395 (2d Cir. 1960), cert. den., 365 U.S. 844 [5 L.Ed.2d 809] (1961); Tomlinson v. Miles, 316 F.2d 710 (5th Cir.), cert. den., 375 U.S. 828 [11 L.Ed.2d 60] (1963).) In Paymer the taxpayers, who were partners, formed two corporations, Raymep and Westrich. Both corporations were given broad powers to own, manage, and dispose of real property. In order to avoid the attachment of partnership property, the partners conveyed a parcel of income producing property to each of the corporations. At the time of the transfer, directors' and shareholders' meetings were held where resolutions were adopted expressly stating that the full beneficial ownership and control of the property remained in the partners and that the corporations were mere title holders. None of the leases were ever assigned to either of the corporations. The partners continued to manage the real estate, collecting therents, paying the expenses, and depositing the income received in the partnership's accounts. The corporate entities were completely ignored as far as the income producing aspects of the properties were concerned. In fact, Westrich did absolutely nothing with respect to the property held in its name. However, Raymep obtained a loan secured by an assignment of all its rights in two leases of the property to which it held title, covenanting that it was the sole lessor.

The court found that Westrich, the inactive corporation, was a mere passive dummy that could be disregarded for tax purposes. However, the court held

that Raymep, the corporation that obtained the loan, was not a mere dummy and could not be disregarded for tax purposes. The court stated:

> We think that Raymep was active enough to justify holding that it did engage in business in 1938. The absence of books, records and offices and the failure to hold corporate meetings are not decisive on that question. Though Raymep was organized solely to deter creditors of one of the partners, it apparently was impossible or impracticable to use it solely for that purpose when it became necessary or desirable to secure the above mentioned loan in a substantial amount.'. ..
>
> Westrich, however, was at all times but a passive dummy which did nothing but take and hold the title to the real estate conveyed to it. It served no business purpose in connection with the.property and was intended to serve only as a blind to deter the creditors of one of the.partners. (Paymer v. Commissioner, supra, 150 F.2d at pp. 336-337.)

The courts have concluded that, although most corporations owned by sole shareholders are "straw corporations" in the sense that the determination of their policies and day-to-day activities are decisions of the individual stockholders and not corporate decisions, that single fact is meaningless for disposition of the tax issue. (National Carbide Corp. v. Commissioner, supra. This conclusion is also reflected in the case of Love v. United States, supra, where the taxpayers were members of a partnership or joint venture whose primary business concern was the operation and sale of real property. Legal title to the venture's income-producing property was held by the Leado Investment Company, a corporation owned by the taxpayers. Proposed deficiency assessments were issued the corporation on the grounds that certain income reported by the individual taxpayers should have been reported as corporate income, and that the individuals should have treated their income as dividends. The taxpayers maintained that Leado was merely a straw corporation used to hold legal title to the property, and that it never engaged in active operations. The taxing authority, on the other hand, argued that the corporation's business activities were sufficient to require it to be recognized as a separate taxable entity.

Among other activities, the corporation executed leases and deeds of trust, entered into agreements of sale, purchased and held insurance policies on its property, employed at least ten employees, and paid the applicable payroll taxes. The court held that the fact that the corporation was used for so many business purposes and was available at all times for such uses precluded a finding that it was a mere phantom organization. Noting that the parties could have elected to conduct their business in other ways, but had elected to utilize the corporate form as insulation against potential -personal liability, the court concluded that the taxpayers could not avoid the resulting tax consequences.

We find that the instant situation is similar to that of Raymep and Leadu and, therefore, is controlled by the decisions of Paymer and Love.. In all three cases, the corporations were created for general purposes concerning the ownership, management, and disposition of real property, and were in fact so utilized. The case for finding that Realty constituted a separate taxable entity is even more compelling than that presented by the decisions cited above in that appellants readily acknowledge that it was a separate entity distinct from its sole shareholder. Appellants seek to argue, however, that while Realty should be considered a separate entity for some purposes, for purposes of this appeal, it should be viewed as the mere holder of. bare legal title to appellant's property. Appellants' argument is without merit. Initially, we note that we a're aware of no authority,, nor have appellants presented any, to support the proposition that Realty should not be considered a separate taxable entity under these circumstances. Moreover, appellants' position that its holding of bare legal title to the property should be determinative as to the issue presented by this appeal is contrary to established legal authority. The criterion set out by the Supreme Court in Moline Properties,, Inc., supra, for determining when a corporation remains a separate taxable entity does not require that the corporation have beneficial ownership of the property; bare legal title is sufficient. (Tomlinson v. Miles, supra; Paymer v. Commissioner, supra; Appeal of Penn Co., Ltd., Cal. St. Bd. of Equal., Feb... 19, 1974.) Finally, the result of the appellate compromise reached between appellants and the Internal Revenue Service with respect to the taxable year 1971 is no.t determinative here. Neither respondent nor this board is bound to adopt the conclusion reached by the Internal Revenue Service in any particular case. (See

Appeal of Der Wienerschnitzel International, Inc., Cal. St. Bd. of Equal., April 10, 1979.) In this case, we have no way of knowing the basis for the aforementioned compromise, in any event, we are satisfied that respondent's determination comports with the law as set forth above.

In accordance with the views set forth above, we conclude that respondent correctly determined that the income and losses derived from the sale and rental of the subject "purchased" properties should be attributed to Realty rather than to appellant.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Sam Armstrong Realty, Inc., against a proposed assessment of additional franchise tax in the amount of $6,533.00 for the income year ended October 31, 1976, and pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Samuel J. and Betty S. Armstrong against proposed assessments of additional personal income tax in the amounts of $4,072.68 and $2,375.77 for the years 1975 and 1976, respectively, be and the same are hereby sustained.

Done at Sacramento, California, this 5th day of April, 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Droneriburg, Jr., Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code Section 7.9